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Hungarian Credit Rating Agency Project

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Prepared for

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Hungarian Credit Rating Agency Project
undertaken by
First Washington Associates, Ltd.
for the
United States Agency for International Development

EXECUTIVE SUMMARY

First Washington Associates, Ltd. (FWA), under a technical assistance contract with USAID, and in cooperation with the Hungarian Banking Association, conducted market research, developed training and development plans, raised capital, and established Focus Investment Rating Company, an independent credit rating agency operating with high international standard methodology. Focus is wholly staffed by, and majority owned by Hungarians. The project is one component of efforts to promote development of a sound, transparent and efficient capital market in Hungary.

By any standard, the project is a significant success that has established an institution able to be a vital positive contributor to Hungary's financial sector development:

- We have established, a credit rating agency operating with the highest international standards of ethics and using international-quality methodology.
- We have heightened the awareness of the market and of regulators of credit, risk, and the value of independent credit rating agencies.
- We have helped highlight the benefits of "western standard" financial market practices, including disclosure and reporting matters, and thus have promoted market maturity in Hungary.
- We have materially influenced the development of regulations and decrees so the results help markets, rather than stifle and distort markets.
- We have provided a basis for professional support to the agency beyond the USAID-support period, further supplying confidence that the project's achievements will be long-lived and self-sustaining.

Our work, which led to Focus, has been well received and respected by government officials. Focus' contribution to Hungarian markets will cut literally years off the time otherwise required to achieve high levels of transparency and efficiency. Accordingly, Hungary's economic development will be enhanced by the project as the capital markets develop with Focus' participation as an independent authority.

Hungary's financial markets have considerable development ahead before reaching the value they eventually will bring to the economy, but they now have a component which most local participants consider essential to market success. Additional changes, principally in the legal and regulatory framework, are required to enhance market transparency and consequent development. General recommendations have been made to the Minister of Finance on this subject. It is possible that Hungary may seek assistance in implementation details. As for the project itself, no further US support is needed.

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I. Background of the Project

A feasibility study undertaken in June 1996 by FSV volunteers for USAID established the appropriateness of this project and of its timing. The First Washington Associates (FWA) Task Order for the Hungarian Credit Rating Agency Project was signed on August 28, 1996. As documented elsewhere, FWA began full-time work on the project in November 1996. A combination of no-cost contract extensions, one contract amendment, and a new contract extended the project to June 15, 1999. A FWA rating agency expert, formerly a Vice President at Moody's Investors Service, a major international full-time credit rating agency, was resident in Hungary working on the project from early 1997 until project completion.

The overall objective was to "further assist with the development of a competitive and market-responsive private financial sector in Hungary through successful completion" of the project. Specifically, the objective of promoting development of the capital markets through promoting increased transparency, availability of independent assessments, and facilitating efficient market pricing was to be realized through establishment of an independent, professional credit rating agency operating with the highest international standards. The Hungarian Banking Association was the local sponsor.

II. Summary of Achievements

By any reasonable standard, the project is a significant success that has established an institution able to be a vital positive contributor to Hungary's financial sector development. FWA notes the following achievements:

- We have established, a credit rating agency operating with the highest international standards of ethics and using international-quality methodology. Focus Investment Rating Company, with initial private-source capital of HUF200,000,000, the majority being Hungarian-owned, is the only such firm in Hungary.
- We have heightened the awareness of the market and of regulators of credit, risk, and the value of independent credit rating agencies.
- We have helped highlight the benefits of "western standard" financial market practices, including disclosure and reporting matters, and thus have promoted market

maturity in Hungary.

- We have materially influenced the development of regulations and decrees so that the results help markets, rather than stifle and distort markets.
- We have provided a basis for professional support to the agency beyond the USAID-support period, further supplying confidence that the project's achievements will be long-lived and self-sustaining. FWA successfully attracted Thomson Financial BankWatch, a major international rating agency, to make a substantial minority investment in Focus, and to provide continuing professional support to Focus.

III. Achievements Relative to Project Tangible Results and Benchmarks.

1. Credit Rating agency is funded and formally established – a country target. Focus Investment Rating Company was funded with HUF200,000,000 (approx. \$1,000,000) equity capital in June 1998. Final papers were signed by the relevant Court of Registration in September 1998. Initial staff training operations actually began in April 1998.

2. FOCUS prepares and commences implementation of its three-year business and marketing plans. FOCUS achieves operational integrity and formulates strategy for commercial viability. FOCUS has achieved operational integrity, has formulated a strategy for commercial viability, and is building a stream of recurring revenue while controlling expenses. Three-year business/ marketing plans were incorporated in the Investment Memorandum, and have been updated periodically based on actual experience.

3. FOCUS establishes a Ratings Committee and develops its internal controls and guidelines. Focus' rating committee was defined in the Investment Memorandum, and the same terms were incorporated in a resolution of the Board of Directors confirming same in July 1998. Internal controls, particularly dealing with ethical standards, signing authorities, and rating procedures were established at the same time. These standards are on a par with those of respected international agencies. In particular, Standards of Conduct established by the internationally-respected Association for Investment Management and Research were adopted by Focus' Board. Operational controls have been further strengthened in accordance with recommendations of the company's auditors, PricewaterhouseCoopers.

4. FOCUS issues at least 10 Credit Ratings - a Country Target. Focus has completed internal ratings of 12 companies, and has completed and issued 4 paid ratings (with a fifth in process) on another 3 firms, although only one firm has chosen to make the ratings public. In addition, Focus is negotiating contracts for over 11 additional ratings, including a group of 15 pension funds, of which 10 would be rated. This is the only shortfall of achievement against targets, and is attributable to the slow-down – virtual halt – of bond issuance in Hungary. The slow-down is believed related to several financial crises, including that of Russia and other countries. In the project's early stages, virtually all observers expected substantially higher issuance activity, and Focus' plans assumed rating of less than half initial issuance. Market conditions appear to be improving, and Focus is also pursuing ratings in sectors such as pension funds not contemplated in the

initial plan.

5. FOCUS develops, at a minimum, two series of specialized products and services. This has been fully achieved. Focus has several series of rating products, including pension funds, investment funds, banks, general corporates, and brokerages. Also, two report products (company profiles and industry surveys) are developed and have each attracted paying subscribers. Marketing of ratings has been underway since late-1998. While it is clear that Focus has not achieved the market presence it seeks, it is clearly recognized as a provider of quality, independent credit assessment, and that is the foundation of long-term success for itself and for the market.

6. At least four Hungarian analysts are trained in credit rating technologies and methodologies and are able to assess risks based on international standards. Exceeded. Training by Resident Advisor begun when staff was hired in April 1998. Five professionals, including Focus' CEO and one additional analyst who is expected to join the staff in late-summer 1999, have on average a sound understanding of rating techniques. The staff has received comprehensive training and experience with basic credit analysis and with several industry-specialized techniques, including pension, process industries and municipal credit. Most training was provided on-site by FWA experts, and supplementary training and exposure was provided in New York City for four Focus professionals. Staff has also been provided and instructed in use of best-available resources, such as international databases, to form sound judgments even in the absence of comparable data on local firms. In addition, by securing an affiliation for Focus with Thomson Financial BankWatch, a respected international rating agency, FWA has provided a quality source of continuing professional support for Focus' staff. Further experience with "live" analysis will continue to foster staff development, which is never truly "finished."

7. At least 20 market participants subscribe to FOCUS products. Exceeded, with a total of 22 subscribers to report products. As these reports gain regular readership, we expect Focus to experience greater demand for them, while enhancing its own reputation and demand for rating and other research services.

IV. Discussion of Project

FWA's work began in November 1996 with preparation of a detailed market diagnostic, which defined the market conditions and outlook, and identified principal challenges likely to be faced in achieving project objectives. This was supplemented with continuing interviews that concurrently sought: consensus on local costs involved; acceptance of plans developed during the period; identification of a CEO to head Focus; and finally investment commitments. An investment memorandum was prepared during the period, which extended to late-Spring 1997. Extensive consultation with the local sponsor, the Hungarian Banking Association (HBA), took place. HBA was a critical partner, having a general understanding of credit rating and the role of credit rating agencies, but looking for more of a formulaic result than creation of the new institutional capability essential to an effective credit rating agency. HBA clearly supported the

project, but was not as active in that support as would have been useful.

Securing firm investment commitments took an unexpectedly long time of nearly a year. While capital raising began in late-Spring 1997, investors first demanded to know who would head the agency. Although the expected CEO had been identified, it was not until July 1997 that his name could be made public. Very little decision-making takes place in Hungary in July, and virtually none in August. Effectively, investment solicitation had to begin anew in September 1997. FWA retained Jozsef Rotyis, who resigned as CEO of the Budapest Stock Exchange in order to pursue the opportunity to head Focus, as a Senior Advisor for the project. The first firm investment commitment was received in early-fall 1997

Many prospective investors wanted to know which international agency Focus would affiliate with – effectively asking what professional support would be available on a continuing basis, notwithstanding USAID-funded support through FWA. (Discussions with each of the international agencies began in early 1997.) Eventually we reached the decision to pursue formal affiliation with Thomson Financial BankWatch. BankWatch appeared to be the most flexible of the agencies in meeting Focus' needs, respected the quality of FWA's support, and also was willing to make an equity investment. Thomson was willing to consider the investment only because of the USAID support, as they were not prepared to undertake full development of a new agency on their own, and were already busy with involvement in other new agencies. We were able to so advise prospective investors of the decision in February 1998. Our choice has proven to be sound. In the near term, it helped move investors to positive decisions, and BankWatch has proven to be a valuable and effective partner for Focus.

During capital raising in late 1997, we faced some unfounded rumors and false allegations from third-parties, regarding, among other things, apparent International Finance Corporation (IFC) support for establishment of another rating agency in the Hungarian Market. This set back our efforts somewhat, and required a diversion of effort to reverse the confusion created in the market and indeed, to "resell" Focus to some potential investors.

Analyst recruitment began in late 1997, and by February 1998 four qualified analysts agreed to join Focus. Three did so by April; the fourth participated in select training and will join Focus in the future. Formal training began in April 1998, anticipating imminent incorporation. FWA arranged additional training and market exposure in New York through World Learning for four Focus professionals, so that they would have additional exposure to rating agency practices. Formal training sessions decreased as subjects were covered, but select supplementary training continued virtually to the end of the project.

Focus moved into its own offices in August 1998, a point that marks a material change in status from "in-formation" to "established." With principal training completed, FWA energies began emphasizing support for regular operation of a rating agency. Additional computer resources were acquired to serve for central database maintenance and eventual publishing layout, and suitable data references were secured. Report formats were settled over a period of months, FWA preferring to secure Focus agreement on development of a

format acceptable to Hungarians while meeting expectations of international financial market participants, rather than imposing a format of FWA's choice. This was typical of FWA's approach throughout the project, namely to have the Hungarian staff develop formats and approaches so far as they met international standards and were effective. While more time-consuming, people are more likely to embrace something they created than something imposed by outside experts.

By 1999, FWA support was directed at supporting regular, recurring activities and standard performance. Of course, concurrent with this was work with individual analysts to polish skills and presentations. "Mock" rating committees were conducted in late 1998, and "live" ratings followed in 1999. Consistent with plan and Focus policy, at least one representative of Thomson Financial BankWatch participates in each rating committee meeting. The experience of Focus' meetings is not substantially unlike what is experienced at established, high-quality agencies elsewhere. This is evidence not only of the effectiveness of training, but also of the quality of Focus' staff.

Throughout the project, FWA has brought in rating agency and other experts where they offered something of value to the project. Subjects ranged from specialized analysis to marketing and broader ethical issues, which are gaining prominence in business globally. On the latter point, we note that the ethical standards of Focus' staff were never at issue – indeed, FWA's expert considered them quite high.

By the mid-June conclusion of the project, all that FWA or USAID could or should do – even given unlimited time and money – was done. Although Focus is not yet operating at a financial break-even, level, it was not anticipated in the business plan that Focus would be profitable in the first two years, other than in optimistic scenarios. However, Focus has an adequate capital base to carry it to profitability, and has a strong, experienced partner to provide continuing guidance. What USAID support has provided is a well-founded institution to serve Hungary, contributing to capital markets in the country (and in time, the region), and materially helping improve the transparency and efficiency of the markets. This will have material benefit to all of the Hungarian economy.

V. Lessons Learned and Suggestions for Future Improvements to Projects

- Things don't happen everywhere as quickly as in the US or in many other countries. This may be particularly acute in countries formerly under governmental systems where individual authority and responsibility were discouraged. For example, in the present case, excuse after excuse was given for not providing investment commitments. In several cases, it was not possible to determine where decision-making authority rested, so many layers were involved. Project plans should reflect this reality.
- A local partner demonstrably committed to more active support of the project would have been beneficial. Every effort should be made to ensure a high level of local partner commitment.
- Without a strong and strongly-committed partner, which we did not have at project

start, and without participation by an international agency, which was not part of the original plan, the project might have failed without regard to its intrinsic excellence. Future projects of this type should be structured around pre-existing strong local financial commitment, and/or an early expression of interest from an international agency, all as a means of assuring local market participants of the durability of the enterprise. It should be noted, however, that most international rating agencies are not willing to start agencies “de novo,” unless the financial markets understand the importance of ratings and a bond market is developing with a strong foundation. USAID can play a key role in fostering an understanding the role of quality independent credit assessment to foster capital market development, and in providing support for development of local credit rating agencies, through projects such as this one in Hungary.

- Notwithstanding problems encountered in implementation, and unexpected frustrations along the way, the project has resulted in a substantial positive contribution to sound market development in a deserving nation. Without USAID support, an institution of the quality of Focus would not appear in Hungary for several more years at the earliest. We now have an institution staffed by, and majority owned by Hungarians, trained in high-quality international methodologies and able to apply them in Hungary. USAID should continue to actively support knowledge-transfer projects of this type.

VI. Additional related action required

The project, while a significant positive accomplishment, will not achieve its full potential, nor will the financial markets and national economy achieve their full potential, without certain changes in the regulatory and legal environment. The critical changes relate to corporate disclosure and transparency, and enhanced comparability of financial reports to more standard international practice. At the same time, caution must be exercised that changes made do not themselves result in unintended results as FWA has seen in other markets. The Hungarian government could, in principal, undertake this on its own, as it is understood to be doing at least in part. However, they may find it useful to secure an outside, independent assessment of the present issues and of proposed changes before they are introduced. USAID support in such a short term assessment, if requested by Hungarian authorities, would be beneficial for the financial markets.

Focus requires no additional US support as it was established with an affiliation with a major international rating agency able to address new issues as they arise.